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RECEIVED

Mr. David S. Guzy
Chief, Rules and Procedures Staff
Minerals Management Service
Royalty Management Program
P. O. Box 25165, MS 3101
Denver, CO 80225-0165

RE: Amendments to Transportation Allowance Regulations for Federal and Indian Leases to Specify Allowable Costs and Related Amendments to Gas Valuation Regulations: 61 FR 39931 (July 31, 1996) and 61 FR 48872 (September 17, 1996)

Dear Mr. Guzy:

I am writing today to submit comments on behalf of the Rocky Mountain Oil & Gas Association (RMOGA) on the above-referenced proposed rulemaking. RMOGA is a regional trade association representing hundreds of members who account for more than 90% of the exploration, production, transportation, refining and marketing activities in the Rocky Mountain West. RMOGA is extremely active in royalty and accounting issues due to our membership, which represents the majority of federal and Indian lessees, both onshore and offshore.

RMOGA members are seriously concerned with the direction in which MMS attempts to be moving through the promulgation of these regulations. While MMS assures industry that these rules are simply the embodiment of current practice and procedure, we strongly disagree.

While there are many areas of concern, the most onerous provisions are those contained in Sections 206.152 and 206.153, "Valuation standards for unprocessed and processed gas". These sections now require that "The lessee must place gas in marketable condition *and market the gas for the mutual benefit of the lessee and the lessor* at no cost to the Federal government..." and "...place residue gas and gas plant products in marketable condition *and market the residue gas and gas plant products for the mutual benefit of the lessee and the lessor* at no cost to the Federal Government..." (emphasis added to indicate new language). What MMS appears to be doing is establishing an elaborate new marketing standard, while at the same time moving the point of valuation further and further away from the lease.

Yet MMS appears unwilling to share the costs of obtaining a higher price at a downstream sales point; instead, deeming them "marketing" costs. MMS would require lessees to bear all costs incurred by the lessee or any subsequent purchaser, regardless of how far downstream of the lease the costs are incurred, how much value is added by those costs, and the fact that a marketable product already exists. We believe this is a thinly disguised attempt to increase revenues to the government at the expense of the lessee.

What is most disturbing to RMOGA members is the implication that failure by a producer to aggregate gas, market downstream of the lease, and obtain the highest price possible may constitute a breach of the lessee's new duty to market. RMOGA believes the creation of this new duty violates applicable statutes and lease terms. Currently, a lessee has no duty to market downstream of the lease and certainly no duty to market through a hub. There looms the specter of auditors making speculative and/or arbitrary determinations that the producer has failed to obtain the highest possible price for his gas.

Finally, to make matters worse, MMS proposes retroactive application of the rule to the "effective date" of the Federal Energy Regulatory Commission's (FERC) Order 636, May 18, 1992. While Order 636 was issued in May 1992, it was not actually effective until November 1993 (and some provisions even later). Retroactive application could result in numerous adjustments required to comply with value determinations made in the illumination of hindsight. Most importantly, the profound changes contemplated in Sections 206.152 and 206.153 are neither a mere clarification of existing policy nor "generally consistent with the existing rule", as asserted by MMS. Instead, there is a decisive shift in policy that creates a whole new duty to market to which retroactive application would be completely inappropriate.

Our specific comments follow. Please note that these comments also apply to Subpart E - Indian Gas as they relate to the corresponding paragraphs of those proposed regulations.

<u>Section 206.152(b)(1)(iv) - How to value over-delivered volumes under a "cash-out" program</u>

MMS states that if it determines the price specified is "unreasonably low", the lessee must value all over-delivered volumes pursuant to paragraphs (c)(2) or (c)(3) of this section. However, we believe if the price paid is specified in an FERC-approved tariff, that price should be an acceptable value to MMS and no penalty should be imposed on the lessee.

<u>Section 206.152(i) - Valuation Standards - Unprocessed Gas</u>

Under the existing regulations, federal and Indian lessees have an obligation to place production in a marketable condition at no cost to the lessor and to market the production for the mutual benefit of lessee and lessor. However, no obligation exists to market production *at no cost* to the lessor. MMS has surreptitiously camouflaged the fact that it is creating a new obligation by first equating the obligation to place production in marketable condition with an obligation to market. Since lessees must bear all the costs to place production in marketable condition, then, MMS construes, it must similarly bear all the costs to market the production. MMS further obscures the new obligation by deducing that the obligation to market production at no cost to the lessor is the same as the lessee's obligation to market for the mutual benefit of the parties. While it is unclear how MMS draws the parallel that all marketing costs must be borne by the lessee simply because some of those costs are the lessees' responsibility, it certainly cannot be inferred that the lessor gets a free ride while the lessee bears all the expense.

Further, no obligation exists to market away from the lease. Indeed, the lessee is only obligated to market *at or near the lease*. The effect of this new obligation would be devastating on small producers. A small producer marketing at or near the wellhead knows the price he receives is the value on which he is obligated to pay royalties. Even though there is a series of markets between the lease and the burner tip, the lessee's obligation to place the product in marketable condition refers only to the first of these markets: at the lease, as defined by statute.

There is a genuine concern MMS will determine that the price paid at the lease is a reflection of and is reduced by all of the costs incurred between the lease and the "new" marketplace — the ultimate point of consumption — and that even though the producer sold marketable gas arm's-length at the lease, he must trace the gas all the way to the burner tip; determine every cost that is incurred by anyone anywhere between the lease and the burner tip; determine whether MMS may regard those costs as "marketing" costs; and, if so, add the costs to the actual wellhead sales price before computing royalties. If certain of these costs, many of which are incurred far away from the lease, are deemed disallowable because there is an implied duty to incur them, does it mean the producer is breaching his duty to market by not *incurring* the costs? While this may not be the intent of MMS, we are alarmed it may well be the result.

RMOGA reminds MMS that all of the unbundled transportation charges it is proposing to disallow have been allowable deductions for decades. MMS asserts that it is only now able to determine which parts of a pipeline tariff are for transportation and marketing; however, MMS has always had the ability to do so, although we concede it is now easier to do so.

Section 206.157(f)(1) - Firm demand charges paid to pipelines

While we agree in principle with MMS that firm demand charges are allowable deductions, we believe the entire demand charge actually paid by a lessee should be allowed. Only when a lessee's actual cost for the demand charge has been reduced by a credit under a capacity release program should the allowance be reduced. Limiting the allowance based on actual use of reserved capacity places the lessee who selects firm transportation at a disadvantage. Gas is seldom produced without a method to transport the gas from the lease. Once a lessee has determined the type of transportation needed, any number of factors beyond the control of the lessee can prevent him from using all his reserved capacity. By disallowing a portion of the demand charge for unused reserved capacity, MMS implies the lessee acted imprudently by incurring costs which could have been avoided and failed to market the gas for the mutual benefit of the parties.

RMOGA recommends the third sentence of this Section be rewritten to clearly state that any gains or losses from the sale of unused firm charges are not royalty bearing. In the fourth sentence, the term "other reasons" is vague at best and provides no certainty whatsoever. MMS should also clarify the fourth sentence to state that refunds received will not be considered gross proceeds if no firm transaction was claimed on the MMS Form-2014.

With respect to pipeline rate adjustments, MMS proposes that if the lessee receives a payment or credit from the pipeline for a penalty refund the firm demand charge must be reduced in calculating the transportation allowance. This implies that a penalty refund is money refunded to the party who paid the penalty, which may not be the case. MMS disallows a deduction for penalties paid by a shipper, but still wants its share of penalty monies refunded to other pipeline customers. This amounts to double-dipping by MMS and is intrinsically unfair.

Section 206.157(f)(2) - Gas Supply Realignment (GSR) costs

We do agree with MMS that GSR costs are deductible allowances; however, we must point out that MMS' attempt to tie the deductibility of GSR charges to its position with respect to gas contract settlements, an issue which is currently being litigated, is an illogical link which, as discussed in the preamble, serves no purpose. Further, the legitimacy of GSR charges as transportation costs will not be influenced by the ultimate resolution of any pending litigation.

Section 206.157(f)(7) - Payments (either volumetric or in value) for actual or theoretical losses

Again, we agree these costs should be deductible but believe MMS should clarify that gas supplied to the transporter for fuel, whether provided in kind or by cash reimbursement, will be an allowable transportation deduction.

Section 206.157(f)(8) - Supplemental costs for compression, dehydration and treatment of gas

In general, compression, dehydration and treatment of gas are not *supplemental* to the transportation of gas; they are an integral part of the transportation process. These charges are often incurred simply because gas is commingled with other gas that has to be treated. We question the term "supplemental" as used in this context and recommend that "other" be used instead. Moreover, MMS admits that gas meeting the specifications of pipelines under the jurisdiction of the FERC is in marketable condition. Once gas is in marketable condition, all subsequent service charges should be deductible, including compression, dehydration and treatment.

Section 206.157(g)(1)(ii) - Banking/Parking Fees

We disagree with MMS' contention that banking and parking fees are for "storage". They are necessary services to maintain balancing at market centers and hubs. There is usually no cessation of movement and MMS even acknowledges that banking and parking fees are often simply "paper" transactions. There is no justification to disallow these costs. In addition, some fees for services are still bundled into package deals with pipeline customers. How will MMS administer these?

Section 206.157(g)(2) - Aggregator/Marketer Fees

To disallow these costs punishes aggressive marketers who are attempting to maximize revenues by moving gas to a better market. Again, there is no obligation for a lessee to aggregate gas prior to sale or to market gas downstream from the lease, and certainly no duty to do so for free once the gas has been placed in marketable condition. If MMS wants to reap the benefits of the higher prices that are obtained through aggregation, it should be willing to share in the costs of obtaining that higher price.

Sections 206.157(g)(3)(i), (ii), and (iii) - Cash-Out, Scheduling and Imbalance Penalties

RMOGA agrees that where reasonable tolerances are provided, costs due to negligence or mismanagement by the lessee should not be borne by the lessor. However, we want to make it clear that no breach of duty to market occurs because no duty to market away from the lease exists. Moreover, MMS should not disallow an actual cost based on an assumption of breach of duty; rather, it should be based on an actual determination that the lessee has failed to act as a prudent operator or shipper. By and large, we believe these penalties can and will be avoided, but we urge MMS to review such penalties on a case-by-case basis in order to determine whether they were unavoidable. Where the penalties were unavoidable, they should be deductible.

Section 206.157(g)(4) - Intra-Hub Title Transfer Fees

Intra-hub title transfer fees (for title transfer tracking) are not marketing costs; they are the cost of using a hub and making a sale at that point. Disallowance of these fees because MMS considers them part of the sales transaction once again punishes aggressive marketers who transport gas through a hub to a better market in order to obtain a higher price. It is imperative to track the title transfer of gas in order to maintain an efficient transportation system. Therefore, these fees are essential to the management of the transportation process and should be deductible.

Still, we are concerned that MMS is maneuvering toward *requiring* all lessees to aggregate production, market downstream of the lease, and obtain the highest price possible, because it implies that, even at a hub, the lessee has failed to meet his duty to market.

Section 206.157(g)(5) - Other nonallowable costs

MMS' implication that lessees may relabel or restructure nondeductible costs as transportation costs is unfounded and unfair. The approach by MMS seeks to defy market realities by taking a free ride on the real costs of selling gas into downstream markets while claiming the benefit of those markets. This cost-shifting creates an economic disincentive to producers to engage in creative and aggressive downstream marketing. It is a given that producers must take these new costs into consideration in making future marketing decisions. It is also a given that the confusion caused by the illogical and artificial criteria used to effectuate this cost-shifting will also affect future marketing decisions and chill creativity. However, to imply that any changes in marketing decisions that may result from this cost-shifting are suspect is like a store owner raising his prices and then accusing his customers of cheating him when they decide to shop elsewhere. We contend all costs incurred to market production after the production has been placed in marketable condition should be allowed and, accordingly, should not be that difficult to determine.

RMOGA urges MMS to allow the deduction of all costs that were previously deductible as part of a pipeline's bundled transportation charge. These are costs over and above the cost of placing production in marketable condition and should therefore be borne by both the lessor and lessee. Clearly, the lessor also benefits if the lessee incurs these costs and is thus able to obtain a higher price for his gas. However, we want to emphasize once again there is no obligation on the lessee to obtain the highest price possible, let alone solely at his own cost.

Specific comments requested by MMS

We will address only that issue not discussed above in our comments.

1. MMS proposes that if a lessee receives a payment or credit from the pipeline for penalty refunds, rate case refunds, or other reasons, the lessee must reduce the firm demand charge used to calculate his transportation allowance reported on the Form MMS-2014 and must modify the Form MMS-2014 by the amount of the refund or other credit for the affected reporting period.

RMOGA agrees with MMS that requiring lessees to adjust prior month reporting is unduly burdensome. Moreover, it fails to meet MMS' objectives of simplifying and streamlining royalty reporting. We recommend for federal leases, the lessee be allowed to report the adjustment in the month received. However, for Indian leases, we do not believe a simplified reporting methodology will be possible, due to the major portion analysis requirement.

Conclusion

Contrary to MMS' assertion, RMOGA does not believe these amendments simply clarify the methods by which gas royalties and deductions for gas transportation are calculated. Instead, they represent an extreme departure from current practice that illegally extends the obligations of federal and Indian lessees.

MMS also asserts the rulemaking will not have a significant economic effect on small producers; the rule will not interfere with protected property rights; the rule is not a significant one requiring OMB review; the rule does not constitute an unfunded mandate; and the rule will not require additional recordkeeping. We disagree.

RMOGA reiterates, there is no duty required of a lessee to market downstream of the lease, much less at the exclusive cost to the lessee. The proposed rule will significantly increase lessees' royalty burden by moving the point of valuation much further away from the lease, and will exponentially increase the lessee's burden by permitting the government to share in enhanced downstream values without paying its share of the downstream costs. Because MMS does not rely on any statute to determine what are and what are not "marketing" costs, it will be impossible to anticipate what downstream costs MMS will disallow, adding to lessees' uncertainty as well as their administrative burden.

In addition, the inevitable appeals and litigation that will result from the creation of this unprecedented duty to market will no doubt be considerable.

Finally, as MMS well knows, retroactive rulemaking has not been viewed favorably by the courts and then only in a very small number of cases based on a very narrow set of circumstances. As noted earlier in our comments, to apply retroactive application to a rulemaking which so profoundly alters the existing duty to market is inappropriate and unwarranted.

RMOGA appreciates the opportunity to provide you with our comments. Please do not hesitate to contact me if you would like to discuss these comments in greater detail.

Very truly yours,

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